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DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 97-0542 ST

Sales/Use Tax — Cleaning Supplies
Sales/Use Tax — Software Licensing Agreements
For Tax Periods: 1994 through 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales/Use Tax — Cleaning Supplies

Authority: IC 6-8.1-3-1; IC 6-8.1-5-1 *et seq.*

Taxpayer protests proposed assessments of Indiana use tax on its purchase of cleaning supplies and materials.

II. Sales/Use Tax — Software Licensing Agreements

Authority: IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-4-10
45 IAC 2.2-4-2; 45 IAC 2.2-5-8(j)
Sales Tax Information Bulletin #8

Taxpayer protests proposed assessments of Indiana use tax on its acquisition of computer software.

STATEMENT OF FACTS

Taxpayer, a retail merchant and commercial printer, produces and sells marketing materials, envelopes, cards, and other types of printed materials. Taxpayer also prints product labels for manufacturers and produces imprinted cartons for use as packaging.

In conducting its business as a commercial printer, taxpayer purchased cleaning supplies and computer software. Taxpayer neither paid sales tax nor self-assessed use tax on these purchases. Audit, in response, proposed additional assessments of use tax. Taxpayer's subsequent protest resulted in the issuance, by the Department, of a letter of findings ("LOF"). The Department

partially sustained taxpayer's protest with regard to the cleaning supplies. But the Department upheld the proposed assessments of use tax on taxpayer's software acquisition.

Taxpayer protests these initial findings. A request for rehearing was timely requested, and granted.

I. Sales/Use Tax — Cleaning Supplies

DISCUSSION

Taxpayer, a commercial printer engaged in manufacturing activities (see IC 6-2.5-5-3(a)(2)), protested Audit's assessment of use tax on purchases of cleaning supplies and materials.

In partially sustaining taxpayer's protest, the Department observed:

> Taxpayer has introduced evidence illustrating the diverse contexts in which the cleaning supplies are used. Taxpayer performs its cleaning activities at three times - during a particular job, between jobs, and at the end of the workday. The Department agrees with Audit's conclusion that cleaning performed between jobs and cleaning done at the end of the workday constitute routine maintenance activities. However, in the context of commercial printing, when taxpayer is required to engage in cleaning activities in order to finish a particular print job, such activities become essential and integral to taxpayer's production process.

And then concluded:

> Since the Department finds that cleaning performed during a particular job or production run is essential and integral to taxpayer's production process, materials used during those activities qualify for exemption under IC 6-2.5-5-3(b) and IC 6-2.5-5-5.1(b). However, when cleaning activities are performed between jobs, between production runs, or at the end of the workday, such use represents post-production maintenance activities. The materials used and consumed in those activities do not qualify for the industrial exemptions - consistent with the language of 45 IAC 2.2-5-8(h) and 45 IAC 2.2-5-12(f).

With regard to the "cleaning" supplies found to be used in production activities, taxpayer's primary concern focuses on the methodology that will be used by the Department to differentiate—pursuant to the initial LOF—taxpayer's non-exempt cleaning activities from its exempt production activities. Taxpayer, in its *Notice of Request for Re-Hearing*, explained:

> [E]ven under the Department's more restrictive view requiring the cleaning to be performed during a particular job, the taxpayer requests a re-hearing for purposes of determining what are qualifying cleaning supplies and [what supplies] are not. Taxpayer has prepared a sampling of weeks during the relevant time period for use as a statistical model and requests the Department's consent to this procedure....

Taxpayer's concerns are premature. Since taxpayer's initial protest was partially sustained, the Department (Audit Division) must revisit the "cleaning supplies" issue. To that end, Audit will conduct a supplemental audit in order to implement the conclusions reached in the initial LOF.

FINDING

Taxpayer's protest is denied.

II. Sales/Use Tax — Software Licensing Agreements

DISCUSSION

Taxpayer protested the assessment of use tax on its acquisition of computer software. Taxpayer presented three arguments. First, taxpayer argued that licensing of software could not be taxed because such transactions did not meet the definition of selling at retail. Second, taxpayer asserted that the opinion in *Lincoln National Life Insurance Company v. Department of State Revenue*, Ind. Cir. Ct., Noble County Docket No. C-80-635 (October 20, 1981), (holding computer software is not tangible personal property), served as controlling authority. The Department rejected both arguments.

Taxpayer also contended its software could not be taxed because the licensing represented use of exempt "customized" software, not nonexempt "canned" software. Taxpayer's argument was summarized in the initial LOF.

> Taxpayer contends that its software meets the definition of custom software because the software is (1) industry specific, (2) sold to only a small number of users (less than 200), (3) purchased as the result of extensive negotiations, and (4) not purchased "off-the-shelf." Additionally, the software required modification to accommodate taxpayer's particular needs. Taxpayer stresses that its software is neither similar nor analogous to taxable "canned" programs which generally are purchased off-the-shelf in shrink-wrapped packages.

In sustaining these proposed assessments, the Department stated:

> The Department recognizes this software agreement entitles taxpayer to use industry specific software - software, taxpayer contends, which has been tailored to meet its specific needs. However, software can be tailored in many ways - ranging from the selection of setup, installation, and configuration options to actual modifications of source code.
>
> It is axiomatic that industry specific software is not re-engineered for each individual licensee. At a minimum, there exists some quantum of source code that resides, initially, in every copy of vendor's licensed software. This "core programming" is the equivalent of canned software, and is taxable.
>
> However, the sale of custom software is not subject to tax in Indiana. Custom software represents a professional service rendered pursuant to 45 IAC 2.2-4-2. (Also see *Sales Tax Information Bulletin #8*). Modifications and additions to the original source code -

> changes made specifically for this taxpayer - represent custom programming services; and as such, are not taxable.

Consistent with the aforementioned analysis, the Department concluded that "[*t]o the extent ... taxpayer's software acquisition represents the purchase of canned software, taxpayer's protest is denied. To the extent that the price of the software license represents coding modifications required to customize software to meet taxpayer's specific requirements, taxpayer's protest is sustained.*"

In response to the conditional denial of its initial protest, taxpayer has provided additional information and argument to buttress its contention that the acquired software license was for "customized" and not "canned" software.

Taxpayer forwarded to the Department a statement (letter dated June 15, 1999) from its software ("Vendor") regarding the customization required to implement the software. Vendor explains:

> [Vendor's] computer software is a customized software program, which allows the [Vendor] to custom assemble the software to fit the unique situation of each customer. We deliver the software to the customer as an empty shell. As the customer is trained during the implementation process, all of the tables, etc., must be customized by the customer [i.e., taxpayer] to fit their unique business needs. ... [Vendor's] computer software can not be installed and put to use like "canned" software. [Vendor] requires many months of training customization prior to being fully implemented in order to educate the customer and to customize the system to meet that customer's requirements.

Taxpayer also submitted additional information in the form of a letter (dated August 23, 1999) and affidavit; each comment on the customized nature of Vendor's software. In substance, the correspondence emphasizes the attributes (as perceived by taxpayer) of "customized" software generally, and of Vendor's software specifically. Cost of acquisition, program utility, necessity of modifications, online support requirements, and time and expenses associated with training and implementation serve to distinguish (according to taxpayer) Vendor's exempt "customized" software from nonexempt "canned" software.

Vendor has developed a highly successful industry-specific software application package (120 installations internationally as of 12/3/99). Vendor currently describes its software system as comprising "a real-time, on-line, multi-user system, providing concurrent access to as many as 1000+ simultaneous users on multiple hardware platforms." In other words, Vendor's software is an "enterprise-wide system compris[ed] [of] fully integrated modules...." The software is both flexible and, depending on modules selected, comprehensive.

After consulting with Vendor, taxpayer purchased Vendor's software package (shell plus modules). Subsequent to purchase—but prior to usage—training, installation, migration, customization, and other implementation activities had to be completed. The Department is not suggesting that such post-acquisition service activities have been or should be taxed. Rather, these activities represent, generally, tax-exempt professional services. (See IC 6-2.5-4-1 and 45 IAC 2.2-4-2). But the necessity of such *post-acquisition* service activities does not transform the character of the software acquired..

Taxpayer sells multiple copies of its software package—albeit with different selections (based on its customers' requirements) of application modules. The programming shell and specific application modules are pre-coded. In other words, the shell and modules are not unique. (Hence, the necessity for post-acquisition modifications.) User groups exist. Vendor's customers receive standardized "programming updates" and "fixes." As Vendor explains:

> Enhancements are routinely made availability to existing users via new releases of general improvements and entire new modules. [Vendor] relies heavily on input from the [User Group] to set priorities for desired enhancements and major new modules.

Together, the aforementioned are all indicia of nonexempt "canned" software.

Computer software is taxable—much like books, sound recordings, and video presentations—regardless of medium used for transfer. However, when software is created for and sold to only one customer, the software represents the provision of exempt professional services. In this instance, taxpayer purchased an industry-specific, comprehensive, software package. The software was not "written" exclusively for taxpayer. The necessity of post-acquisition activities may be indicia of the software's complexity and comprehensiveness—but not of its "customized nature.

Because of the software's flexibility, comprehensiveness, and relatively open architecture, the time and resources committed to software implementation—i.e., the steps necessary to get the software "up and running"—were considerable. However, no evidence exists, or has been presented, to suggest these professional services were performed prior to taxpayer acquiring its software or represent pre-acquisition modifications of source code. The "customization" referred to by taxpayer was part of the software implementation process. Additionally, no evidence has been presented to suggest that Audit proposed assessments of use tax on the costs of these professional services. Consequently, the Department must endorse its initial findings.

FINDING

Taxpayer's protest is denied.

PE/BK/MR—000809